

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
PETITION FOR
REHEARING
EN BANC**

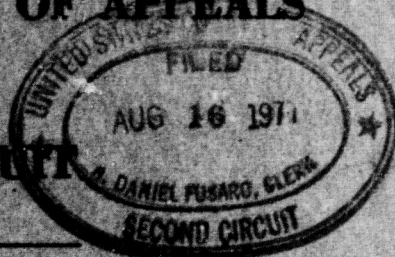
ORIGINAL
WITH PROOF
OF SERVICE

77-60002

UNITED STATES COURT OF APPEALS

for the

SECOND CIRCUIT



COMMODITY FUTURES TRADING COMMISSION,

Plaintiff-Appellant,

v.

BRITISH AMERICAN COMMODITY OPTIONS CORP.,

Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

PETITION FOR REHEARING OF BRITISH
AMERICAN COMMODITY OPTIONS CORP., APPELLEE

en banc

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PRELIMINARY STATEMENT

The undersigned, on behalf of the defendant British American Commodity Options Corp. ("British American") hereby submits this petition for rehearing. The decision of the Court filed August 3, 1977 will, if allowed to stand, result in the immediate loss of some three hundred jobs and adversely affect the rights of some 10,000 customers while denying the defendant the opportunity to submit documentary and oral evidence at an evidentiary hearing on the preliminary injunction.

The principal grounds which require reconsideration are:

1. The Court's decision completely overlooks that the District Court's order denied the motion of the Commodity Futures Trading Commission ("CFTC") for a preliminary injunction at the close of the plaintiff CFTC's case and thus was rendered prior to the introduction of any evidence by the defendant. The Court's instructions to the District Court, if allowed to stand, would deprive the defendant of its due process right to submit evidence in its defense.

2. The Court's decision presupposes that commodity option trading was a regulated industry which defendant entered with full knowledge of an existing regulatory scheme, thereby overlooking that at the time of defendants' organization in October 1975 and prior to December 9, 1976 the CFTC not only did not have a regulatory scheme applicable to commodity option dealers but prior to March 1976 the CFTC staff advised defendant that they did not know whether or not they had jurisdiction over defendant.

3. The Court adopted the CFTC's thesis raised for the first time on oral argument that the injunction requested would merely limit defendant's business rather than effectively terminate it. This theory is legally and factually without merit.

4. The Court in finding the likelihood of future violations to imply a significant injury to the public (slip op. p. 5112) overlooks the fact that there was no allegation in the complaint below of fraud or other injury to the public and that accordingly the holdings in cases such as SEC v. Management Dynamics, Inc., 515 F. 2d 801, SEC v. Culpepper, 270 F. 2d 241 and FTC v. Thomsen-King & Co., 109 F. 2d 516 which involved active fraud and/or the sale of unregistered securities are inapposite. The defendant can show that under this particular regulatory scheme its operations were subject to all of the objective criteria of the statute and regulations promulgated thereunder and that so long as it complied with all of those provisions, no public harm could result from its remaining in business pending the determination of its fitness to be registered.

5. The Court erred in finding that the CFTC had proper grounds prior to a hearing to refuse to grant the defendant's application for registration as a commodity trading advisor ("CTA") under the provisions of 7 U.S.C. §6n(7) and 7 U.S.C. §12a(2)(b)(ii).

I

THE DEFENDANT HAS
A RIGHT TO BE HEARD

The District Court, after denying defendant's motion to dismiss on the grounds of primary jurisdiction, in conformity with Rule 65(b) of the Federal Rules of Civil Procedure, set the CFTC's motion for a preliminary injunction down for a hearing. Its order denying the CFTC's motion was rendered at the close of the CFTC's case and the defendant was accordingly not afforded the opportunity of introducing evidence on its behalf.

This Court's mandate directing the District Court to issue an injunction denies the defendant the right to present evidence in the required hearing, contrary to prior decisional law in the Second Circuit and other jurisdictions. SEC v. Management Dynamics, Inc., 515 F. 2d 801 (2d Cir. 1975); SEC v. Spectrum Ltd., 489 F. 2d 535 (2d Cir. 1973). In accord: SEC v. National Student Marketing Inc., 502 F. Supp. 641 (D.C. Dist. of Col. 1975); SEC v. Charles A. Morris Associates, 72-73 CCH Fed. Sec. L. Rep. ¶93, 756 (W.D. Tenn. 1973).

If the District Court erred, its error was in not completing the hearing. The defendant should not be deprived of its day in court solely on the basis that it was diligent below and successful in prevailing at the close of the plaintiff's case.

It is well settled that where a matter is dismissed at the close of the plaintiff's case and the dismissal is reversed, the case should be remanded to give the defendant the right to present his case. United States v. U.S. Gypsum Co., 333 U.S. 364, 68 S.Ct. 525, 92 L. Ed. 746 (1948); 340 U.S. 76, 71 S. Ct. 160, 95 L. Ed. 89 (1950); White Rimrock Tidelands, Inc., 414 F. 2d 1336 (5th Cir. 1969); Riegel Fiber Corp., v. Anderson Gin Co., 512 F. 2d 784 (5th Cir. 1975); Gulbenkian v. Gulbenkian, 147 F. 2d 173 (2d Cir. 1945). By precluding the defendant from putting in its case this Court is preventing the exercise of equitable discretion by the District Court. As the Court's opinion notes "there is always some measure of equitable discretion even in statutory injunctive actions". (slip op. 5113)

II

CONGRESS SET UP NO SCHEME FOR THE REGULATION OF COMMODITY OPTION TRADING

While the Court's decision rests on the assumption that Congress devised a comprehensive scheme of regulation of which "[r]egistration is the kingpin" it is clear from the legislative history and the Commodity Exchange Act, as amended, (the "Act") itself that this "statutory machinery" applies to trading in commodity futures but not options. The legislative committee reports (S. Rep. No. 93-1131, pp. 41-42; H.R. Rep. No. 93-975, p. 31; Conf. Rep. No. 93-1383, p. 40; 93d Cong., 2d Sess. 24 (1974)) make clear as does the statute itself (7 U.S.C. §6c(b)) that the Congress left to the sole

and absolute discretion of the CFTC whether to permit or ban trading in commodity options and if such trading was to be allowed the terms and conditions under which it would be permitted.

Accordingly, Congress felt no need to devise a comprehensive scheme for regulating commodity option trading since for all it knew when it amended the Act in 1974 trading in commodity options might shortly be banned entirely U.S.C §6c(b).

Thus, while the Court correctly states that defendant commenced business after the effective date of the Act (April 21, 1974) it is not correct in assuming that a full blown regulatory scheme existed to greet its birth.

Defendant can show that from the time it commenced business, the CFTC and the SEC were aware of its existence and each agency advised the defendant that it did not know whether or not it had jurisdiction over commodity option trading; that the CFTC was on numerous occasions prior to March 1976 given access to the defendant's premises and was furnished with its back office data, marketing literature, etc., in addition to numerous telephone contacts; that defendant voluntarily complied with all requests of the CFTC staff for documents and other information and even though the CFTC staff did not claim jurisdiction revised its marketing literature to reflect criticisms, as shown by the marketing literature used by defendant after December 1975.

The Court's assumption that the CFTC first learned of defendant's activities on March 3, 1976 (slip op. p. 5105) is not supported by the record. In fact, it is conceded by the CFTC that defendant was one of the first commodity option dealers to file for registration as a CTA and the record in the administrative proceeding and the rule making process would clearly show that it was the defendant's position before the CFTC that the CFTC had no jurisdiction over it as a commodity trading advisor but there should be a separate classification for commodity option dealers as contemplated by the regulations proposed on February 20, 1976.

It is significant that the first regulation promulgated by the CFTC providing for the registration of commodity option dealers was not published until October 8, 1976 (41 Fed. Reg. 44560 et seq.)¹ almost one year after defendant commenced doing business. The CFTC in its brief to this Court in the regulations litigation, British American Commodity Options Corp., et al v. William T. Bagley, et al, 552 F. 2d 482 (1977) concedes this fact stating on page one:

1. These were withdrawn and republished in amended form on November 24, 1976 (41 Fed. Reg. 51808).

"The challenged regulations were adopted by the Commission primarily under authority of Section 4c(b) of the Commodity Exchange Act, as amended, 7 U.S.C. §6c(b), and are the first stage of a two-step comprehensive regulatory scheme under which the Commission proposes to implement its Congressional mandate effectively to regulate option trading in the United States."
(emphasis added)

On August 8, 1977 Mr. Justice Marshall, as Circuit Justice, in a related matter, Commodity Futures Trading Commission, et al v. British American Commodity Options Corp., et al, No. A-86 (77-96) in which the defendant and others are challenging the validity of these very regulations found on page 2 of his opinion:

"Pursuant to this authority the Commission immediately adopted an antifraud rule, and on November 24, 1976, after informal proceedings, the Commission promulgated a comprehensive set of regulations...."

III.

THE COURT MISAPPLIED THE BALANCE OF INTERESTS

The Court's decision that an injunction should issue in addition to denying the defendant its right to be heard as discussed above, rests erroneously on the theory that "a finding that future violations are likely to occur implies that a significant injury to the public has been shown" (slip op. p. 5112). In reaching this conclusion the Court relies on decisional law which it is submitted is clearly inapposite, dealing with ongoing active fraud which is not present in the instant case.

The Act and the regulations thereunder, anti-fraud, disclosure, financial requirements, the right to inspect, reparations, etc. are applicable to all persons engaged in trading in commodity options, whether or not registered. The defendant has accordingly, been at all times subject to all of the weapons in the CFTC's regulatory arsenal.²

Eg. 40 Fed. Reg. 26504 (June 24, 1975), 41 Fed. Reg. 51808 (November 24, 1976). The CFTC's complaint in this action, which was filed over 3 months after the administrative complaint, did not contain one allegation that defendant was violating any provision of the Act or rules promulgated thereunder except it was not yet registered. If in fact the defendant was violating any provision relating to the public, most assuredly the CFTC would have alleged and attempted to prove it.

Furthermore, it can be shown that defendant's marketing brochure was a model upon which the disclosure requirements of Sec. 32.5 of the regulations are based. It can be shown that the defendant developed the first and most comprehensive compliance manual in the industry and numerous other innovations for the public's protection.

2. That the CFTC has deemed the defendant to be subject to its regulations even though not registered is evidenced by correspondence from General Counsel to the defendant after the promulgation of Section 32.6 ("double segregation") inquiring how the defendant would comply and what steps had been taken toward compliance. The provisions of Section 32.6 have been stayed by this Court pending the defendant's petition to the Supreme Court for a Writ of Certiorari. The CFTC's motion to vacate the stay of mandate was denied by Justice Marshall of the Supreme Court of the United States on August 8, 1977.

It can be shown that defendant has consistently and actively participated in the rule making process, to the extent public participation has been invited and permitted by the CFTC.³

The instant case is therefore clearly distinguishable from the cases cited by the Court, which involved the sale of unregistered securities, fraud and market rigging or fraudulent advertising, clearly harmful to actual and potential investors.

There is no allegation in this proceeding that defendant has failed to comply with any of the objective criteria of the Act or regulations aimed at the protection of the public interest. The only allegation is that it is not registered and in this respect it has done everything it can do. As discussed below, the CFTC's refusal to grant it registration without a hearing is unwarranted and unlawful.

IV

THERE WERE NO LAWFUL GROUNDS FOR REFUSING DEFENDANT REGISTRATION AS A COMMODITY TRADING ADVISOR PRIOR TO A HEARING

The two sections of the Act on which the CFTC relies for withholding their approval of the defendant's application

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3. In fact on February 20, 1976, the CFTC published proposed regulations relating to commodity option transactions which recommended that dealers such as the defendant register in a new category called "commodity option dealer" 17 C.F.R. volume 41 part 32 at pp. 7776-7777 (February 20, 1976) The defendant was, based on information and belief, the only commodity option dealer to participate in and furnish business data in this series of public hearings. Yet two weeks later the staff was taking the position the defendant should register as a commodity trading advisor. The defendant can show that it has always been its position that this should be a regulated industry.

for registration without a hearing as a CTA are 7 U.S.C. §6n(7) and 7 U.S.C. §12a(2)(b)(ii), basing their reliance on the prior consent injunctions of John Forma involving net capital and bookkeeping violations under the Securities Exchange Act of 1934, 15 U.S.C. §78a et seq. and allegations of customer fraud in the administrative complaint against the defendant filed April 16, 1976.

Dealing with the fraud allegations first it can be shown: that the CFTC had no evidence of customer fraud whatsoever when the administrative complaint was issued; that the CFTC staff surreptitiously obtained defendants customers list two days prior to the filing of the complaint; and that, after the administrative complaint was filed and publicized, the CFTC instituted an intensive complaint solicitation program in an attempt to obtain evidence using tactics severely criticized by the courts. CFTC v. Rosenthal & Co. et al. 76 Civ 3904 (N.D. Ill. E.D. April 26, 1977) The net effect of this Court's ruling is to invest mere bureaueratic allegations, which at the time made, have absolutely no basis in fact, with an aura of absolute finality not subject to challenge by the party charged or to judicial scrutiny.

As for John Forma's injunctions they clearly form no basis for denial prior to hearing of defendant's application for registration under 7 U.S.C. 6n(7). While §6n(7)(b)(ii) permits denial of registration where a partner, officer, etc. of a CTA "at a time of the issuance of the order" is enjoined "from engaging in or continuing any conduct or practice. . .

in connection with the purchase or sale of commodities or securities", it is well settled that violations such as net capital or bookkeeping are not deemed "in connection with the purchase or sale of securities". §6n(7), which is specifically applicable to CTA s, by definition is only applicable to defendant after a hearing.

Turning to 7 U.S.C. §12a(2)(b)(ii) the Court's reliance upon this provision is, it is submitted, misplaced and unwarranted. As a matter of accepted statutory construction "other good cause shown" should not as the CFTC with the approval of this Court has done be treated as general catch-all but must be read as encompassing causes similar to the other causes specifically stated. Pulvers v. Commissioner of Internal Revenue, 407 F. 2d 838 (9th Cir. 1969); Flying Tiger Line v. C.A.B. 204 F. 2d 404 (D.C. Cir. 1953). U.S. Gypsum Co. v. Mystic River Bridge Authority, 329 Mass. 130, 106 NE 2d 677 (1952)

The other causes specified in §12a(2)(b)(i) are (1) prohibited conduct under the Act; (2) conviction of a felony; (3) debarment from contracting with the United States; and (4) willful misrepresentations in connection with the application for registration, none of which "causes" bear any similarity to consent decrees before another agency, without admitting or denying, based upon bookkeeping and net capital requirements. Furthermore, the use by the CFTC of a consent injunction instituted by another agency, without admitting or denying, entered into prior to the specification of this as "good cause" by a general counsel's interpretive release after British American commenced operations as a reason for denying it a license without

a hearing is clearly violative of due process. Rachal v. Hill, 435 F. 2d 59 (5th Cir. 1970) cert. denied, sub nom Hill v. Rachal, 403 U.S. 904 (1971).

It is respectfully submitted there is no legal basis for a finding that bookkeeping or net capital violations are within the defined term "in connection with the purchase or sale of a security". There is no precedent for such a finding in connection with the denial of a broker-dealer license under Section 15 (b)(4)(C) of the Securities Exchange Act of 1934, as amended. The closest analogy is the anti-fraud provision of Section 10(b) of the Exchange Act and Rule 10 b-5 promulgated thereunder and the cases uniformly require that violative conduct have a more direct bearing upon the purchase or sale of securities.⁴

V.

THE COURT OVERLOOKED
THE VIOLATIONS OF DUE
PROCESS INHERENT IN THE ACT

While the Court's decision gives lip service to the prejudice inherent in the failure of the CFTC to act on the

4. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 95 S. Ct. 1917, 44 L Ed. 2d 539 (1975); reh den 423 U.S. 884 96 S. Ct. 157 46 L Ed. 2d 114 (1975); Ernst & Ernst v. Hochfelder 425 U.S. 185, 96 S.Ct. 1375, 47 L Ed. 2d reh den 425 U.S. 986, 96 S. Ct. 2194 48 L Ed. 2d 811; Barnett v. Anaconda Co., 238 F. Supp. 766 (S.D.N.Y. 1965); Boone v. Baugh 308 F 2d 711 (8th Cir. 1962) Bolger v. Leventhol Krekstein, & Howarth & Howarth CCH Fed Sec L Rep ¶ 94,618 (S.D.N.Y. 1974).

defendant's application with dispatch it concludes that such are wrongs without remedy. Were this a situation such as the securities field where regulation has been established for over 40 years, the fact that a new entity might have to wait its turn to be processed could possibly be condoned even though such wait were longer than a Court might feel reasonable.

Where the regulatory scheme relating to commodity option trading in general and this defendant in particular came into effect over one year after the company began operation it is unconscionable to permit, as the Court would seem to do, the arbitrary withholding of registration by the CFTC (in this case for over one year) while it sets its own pace and as the Court states uses its expertise in evaluating registration applications and "delaying a hearing".

The Court thus leaves applicants for registration at the complete mercy of a bureaucratic machine which it concedes in its decision to be in less than first rate running order.

While 7 U.S.C §§9 and 12a give the unsuccessful applicant the right of appeal such right only arises upon the denial of registration after hearing, an exhaustion of administrative remedies being first required. Accordingly, by simply refusing to act the CFTC can apparently prevent an applicant from doing business for an unlimited time, and deprive it, under this Court's decision, of any meaningful forum in which its rights may be adjudicated.

The Court's decision would apparently preclude the defendant from raising in its defense the propriety and legality

of the CFTC's failure to act and would apparently overrule the District Court's holding that

"While the CFTC's failure to hold a timely hearing is not a violation of the Commodities [sic] Exchange Act, it may in some instances be violative of constitutional due process. " 422 F. Supp. at 654

Although the opinion of the District Court was issued on October 20, 1976, after the conclusion of the evidentiary hearing the staff requested and obtained time extensions of over 60 days to file their post hearing briefs.

If the CFTC is permitted as it has in this case to delay inordinately on untenable grounds an application for registration, an applicant, such as British American, under this Court's decision can be denied the right to earn a livelihood in clear violation of its constitutional rights. Yick Wo v. Hopkins, 118 U.S. 356 (1886).

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5. The staff's reason for the delay was subsequently revealed when realizing that the evidence in the initial administrative proceeding did not substantiate the fraud allegations they felt additional time was needed to obtain other witnesses for the second proceeding as to which the complaint was amended immediately before the evidentiary hearing. The constitutionality of the registration provisions of Section 32.3 of the new regulations are among other factors the subject of a petition for a writ of certiorari in the United Supreme Court in British American et al v. William T. Bagley et al, No. 77-96, this Court having granted a stay pursuant to FRAP §41(b).

VI

THE ISSUANCE OF THE
INJUNCTION WILL PUT THE
DEFENDANT OUT OF BUSINESS

For the first time at oral arugment the CFTC unveiled the thesis that the injunction sought by them would not put che defendant out of business but would merely prevent it from rendering commodity trading advice. The Court adopted this position. (slip op. p. 5113)

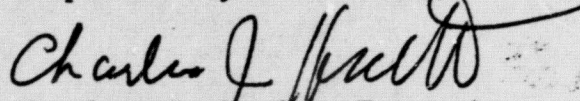
This finding overlooks the extremely broad interpretation which the courts have over the years given to the term "instrumentality of interstate commerce" under which the defendant could not comply with the anti-fraud and disclosure regulations (Sections 32.5, 32.8 and 32.9) except by direct personal contact. In fact it is doubtful if the defendant could even advise potential or actual customers of the price of the option by telephone or mail confirmation slips since, if the Court's categorization of the defendant as a "CTA" is correct, the use of the mails or any means or instrumentality of interstate commerce to advise a customer "as to the value of commodities" would be denied it. 7 U.S.C. §§2 and 6m.

Accordingly, the theory that the defendant could continue in business to offer and sell commodity options so long as it did not give commodity trading advice is a legal fiction without substance.

CONCLUSION

British American respectfully request that this Court
grant its petition.⁶

Respectfully submitted


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By David Greene

Dated: New York, New York
August 15, 1977

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6. It is respectfully suggested to the panel that since (i) this case presents the first challenge to the constitutionality of the Act and the regulations thereunder with respect to the registration of CTA s and (ii) the Court's decision apparently overrules the long standing right in this Circuit to a hearing on a motion for preliminary injunction, this petition may be appropriate for an en banc hearing.

STATE OF NEW YORK)
COUNTY OF NEW YORK) ss .

RICHARD WITHERS, being duly sworn,
deposes and says that deponent is not a party to the action,
is over 18 years of age and resides at 1526 Webster Ave. Apt. B-3
Bronx, NY 10457.

That on the 16 day of AUGUST, 1977,
deponent personally served the within PETITION FOR REHEARING
OF BRITISH AMERICAN COMMODITY OPTIONS CORP, APPEALS
upon the attorneys designated below who represent the
indicated parties in this action and at the addresses below
stated which are those that have been designated by said
attorneys for that purpose.

~~By leaving true copies of same with a duly~~
~~authorized person at their designated office.~~

By depositing 2 true copies of same enclosed
in a postpaid properly addressed wrapper, in the post office
or official depository under the exclusive care and custody
of the United States post office department within the State
of New York.

Names of attorneys served, together with the names
of the clients represented and the attorneys' designated
addresses.

RICHARD NATHAN, Esq.
DEPUTY GENERAL COUNSEL
COMMODITY FUTURES TRADING COMMISSION
PLAINTIFF-APPELLANT
2033 K STREET, N.W.
WASHINGTON, D.C.

Richard Withers

Sworn to before me this

16 day of August, 1977
Michael DeSantis

MICHAEL DeSANTIS
Notary Public, State of New York
No. 03-0930908
Qualified in Queens County
Commission Expires March 30, 1979

